Order preferencing and market quality on NASDAQ before and after decimalization

Kee H. Chung\textsuperscript{a,\,*}, Chairat Chuwonganant\textsuperscript{b}, D. Timothy McCormick\textsuperscript{c}

\textsuperscript{a} Department of Finance and Managerial Economics, State University of New York (SUNY) at Buffalo, Buffalo, NY 14260, USA
\textsuperscript{b} Department of Accounting and Finance, Indiana University-Purdue University at Fort Wayne, Fort Wayne, IN 46805, USA
\textsuperscript{c} The NASDAQ Stock Market, Inc., Rockville, MD 20850, USA

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Abstract

Despite the widely held belief that order preferencing affects market quality, no hard evidence exists on the extent and determinants of order preferencing and its impact on dealer competition and execution quality. This study shows that the bid-ask spread (dealer quote aggressiveness) is positively (negatively) related to the proportion of internalized volume during both the pre- and post-decimalization periods. Although decimal pricing led to lower order preferencing on NASDAQ, the extent of order preferencing after decimalization is higher than what prior studies had predicted. The price impact of preferred trades is smaller than that of unpreferred trades and preferred trades receive greater (smaller) size (price) improvements than unpreferred trades.

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*Corresponding author. Tel.: 716-645-3262; fax: 716-645-2131.
E-mail addresses: keechung@buffalo.edu (K.H. Chung), http://www.acsu.buffalo.edu/~keechung/.

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1. Introduction

Brokers and dealers on NASDAQ routinely direct or preference customer orders to any dealer who agrees to honor the best quoted price regardless of the price quoted by the dealer to whom the order is directed. In return for the routing of orders, dealers commonly offer either direct monetary payments or in-kind goods and services to brokers. Brokers and dealers also frequently internalize their order flow on NASDAQ. Internalization, a subset of preferencing, is the direction of order flow by a broker-dealer to an affiliated dealer or order flow executed by that broker-dealer as market maker.

Although prior studies offer both analytical predictions and experimental evidence regarding the effects of order preferencing on execution costs, extant studies offer limited evidence on the extent and determinants of preferencing and its impact on market quality. In the present study, we address the following questions using a large sample of NASDAQ-traded stocks: (1) How extensive is preferencing on NASDAQ? Which stocks, which dealers, and which trades are more likely to be involved in preferencing? (2) How does decimal pricing affect preferencing? (3) How does preferencing affect spreads and dealer quote aggressiveness? (4) Does preferencing allow dealers to separate informed traders from uninformed traders? and (5) Do preferred orders receive better price and size improvements?

Several studies analyze order preferencing for exchange-listed stocks. Hansch et al. (1999) investigate the effect of preferencing and internalization on spreads and dealer profits for a sample of London Stock Exchange (LSE) stocks. The authors find that while preferred trades pay higher spreads, they do not generate higher dealer profits. In contrast, they find that internalized trades pay lower spreads. However, the study finds no evidence of significant relations between the spread and preferencing or internalization across stocks. Although the LSE, like NASDAQ, is largely a dealer market, the results found on the LSE may not hold on NASDAQ because dealer competition for order flow on the LSE is different from that on NASDAQ. On NASDAQ, there are more than 400 market makers competing for order flow. In contrast, there are only 21 market makers on the LSE and the majority of them compete for business primarily in the large (FTSE-100) stocks. Furthermore, it is illegal on the LSE to make

\[ \text{1See Christie and Schultz (1994), Battalio and Holden (1996), Godek (1996), Huang and Stoll (1996), } \\
\text{Dutta and Madhavan (1997), Kandel and Marx (1997, 1999), Bloomfield and O’Hara (1998), Ackert and } \\
\text{Church (1999), Bessembinder (1999), and Chung et al. (2001).} \]
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